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Introduction

Orkun Akseli, Joanna Gray and Andrew Campbell

The genesis of this collection of essays lay in discussions within Newcastle Law School and more widely within Newcastle University as we witnessed the dramatic events of September 2007 with the run on the Newcastle-based Northern Rock bank. Those discussions broadened in scope as to areas of the law and regulation that they invoked as the twists and turns of the attempted rescue, nationalisation, emergency changes to legal and regulatory provisions to deal with the now-spreading banking crisis ran their course. As the immediate panic of Northern Rock subsided, fresh flurries of panic and instability loomed elsewhere in the financial world from Iceland to the US to the new and emerging financial centres of the Middle and Far East, where theories of decoupling began to look distinctly shaky. Gradually, more considered post mortems took place and longer-term law reform began to be discussed and implemented. But the fact that the ripples or early warning tremors of what we now know to have been a truly global financial crisis of an unprecedented scale were first felt here in the North East of England, a proud and distinctive region but nonetheless hardly a financial powerhouse, as one of the significant employers and oldest and most important large, private sector companies met its nemesis, we thought was worthy of marking by contributing reflections from our different legal backgrounds and scholarly interests. We used the run on Northern Rock and the events preceding and following it as an organising lens through which to consider different aspects of how law, legal processes and regulation could be said to have contributed (if at all) to Northern Rock's difficulties, how it was used in the immediate aftermath of the bank run, how it was used and shaped by the nationalisation, how the financial crisis looks set to result in longer-term reform of law and regulatory institutions to prevent

its like recurring and, finally, whether a growing alternative legal model offers a different and safer legal basis for organising financial exchange and intermediation in the future.

It is worth recalling the history of Northern Rock bank, which had converted from the legal status of building society to that of bank after changes were made to the laws relating to building societies in the mid-1980s¹.

The history of Northern Rock bank begins in the city of Newcastle upon Tyne in the north of England in 1850 with the formation of the Northern Counties Permanent Building Society. Fifteen years later the Rock Building Society was established in the same city and in 1965 these two building societies merged to form the Northern Rock Building Society. Both of the two building societies, which came together to form Northern Rock, had very conservative histories with business models that consisted of attracting deposits from members of the public and then using a large proportion of this to lend on fully secured residential mortgages. One of the characteristics of the lending policy was how risk-averse it was. Borrowers were required to have steady employment and a sizeable deposit to put towards the purchase of a property. In addition, borrowers were required to have been saving members of the society for a considerable period of time before the society would even consider lending to them.

By the time Northern Rock became a public limited company, on 1 October 1997, it actually consisted of an amalgamation of 53 building societies. These had all been based in the north-east of England and most were extremely small and localised institutions.

To make demutualisation an attractive option to the membership all members, savers and borrowers, were offered free shares in Northern Rock plc. Both borrowing and saving members received 500 shares each. Prior to the actual vote, the UK media made it clear that this 'windfall' would be worth a significant amount to the members of the society. The prospect of being able to immediately sell the shares on the stock market and making a quick, and for most a tax-free², profit was a very attractive proposition for the vast majority of Northern Rock's members. Other members, who felt a long-term commitment to the institution and who intended to hold the shares rather than sell them, were generally swayed by the argument that as they were already owners of the institution it would be better to hold an ownership right which would have a specific value

and which could be sold whenever the shareholder deemed appropriate. As a building society this ‘membership/ownership’ right existed but could not be turned into anything tangible. Only if the management of the society decided to distribute surpluses to the members would the member be in a position to benefit from their ownership rights. Most building societies, including Northern Rock, had been accumulating surpluses and retaining them without any such distributions to members. Demutualisation was therefore a way of unlocking this value for members. This was a powerful argument, so when the Board of Directors recommended acceptance of the proposals for demutualisation there was never any real doubt about how the membership would vote³. As Gray points out in her contribution to this work, some of those original early demutualisation shareholders are finding the courts a cold place now that they are engaged in legal action, seeking compensation in relation to what they see as that shareholder value lost, arbitrarily and unfairly stripped out of the nationalised company by what they argue to be a flawed legislative basis for the nationalisation of Northern Rock in February 2008.

The events which took place at Northern Rock and such other well-known former building societies as the Halifax, Leeds Permanent, Bradford and Bingley, Alliance & Leicester and Dunfermline were both dramatic and traumatic. This is true not only for these banks and their shareholders, but also for the communities in which they are, or were, based. The shock of witnessing the run at Northern Rock live on national television had a damaging effect on the morale of the north-east of England. At the same time the dramatic demise of both the Halifax⁴ and the Bradford & Bingley hit West Yorkshire particularly hard. Both of these English regions and their communities had come to depend on these financial institutions as providers of secure and stable employment for many thousands in the local communities. It was initially inconceivable to the average person that such historically safe and important financial institutions could be in trouble. Indeed, because these banks had emerged from former building societies it was still the case that many of the shareholders were local people of modest financial means who would not normally be expected to invest in the stock market. The change of status from building society to bank was something that would have been little understood by the average person. After all they operated with the same names, from the same premises and with the same members of staff.

It is ironic that a piece of legislation which had come into being as a result of the Building Societies Association's proposals to strengthen the building society industry, in reality, had the opposite effect. All of the major building societies, with the exception of Nationwide, used the power to convert to PLCs. It is also ironic that this eventually led to the introduction of a bank insolvency framework for the UK, considered in detail here by Campbell in his discussion of the Special Resolution Regime introduced by the Banking Act 2009. Following the publication of the new government's proposals for a reform of financial regulation in the UK, considered here by Gray, it is now clear that elements of that new bank insolvency regime are set to change further. Nevertheless, the account provided here by Campbell is valuable in showing how the protracted and clumsy attempts to rescue and salvage value from Northern Rock following September 2007 led to the crafting of a bespoke insolvency regime for banking institutions, something the UK had been lacking despite the size and systemic importance of its banking sector.

After the members voted overwhelmingly in favour of conversion from a building society to a public limited company in 2001, Northern Rock became listed on the London Stock Exchange, eventually becoming only the second company based in the north-east of England to achieve the status of membership of the FTSE 100.

After becoming a bank Northern Rock started to grow rapidly and by 2007 had 70 branches throughout the UK⁵. Its assets, on a consolidated basis, had grown from £15.8 billion at the conversion date, 1 October 1997, to £101.6 billion at the end of 2006⁶. This spectacular growth rate led to Northern Rock entering the FTSE 100 in September 2001. Northern Rock continued to be a mortgage bank and by the end of 2006 approximately 90 per cent of its assets were residential mortgages⁷. Assets had, in fact, been growing at around 20 per cent a year, which was a considerably higher than average rate for a mortgage bank and which, on reflection, should have been seen as a matter of concern by the relevant regulator, the Financial Services Authority.⁸ Gray makes reference in her contribution to the performance, both of the FSA in its supervision of Northern Rock in the period leading up to the bank run, as well as that of the Tripartite Authorities in their broader stewardship of UK financial stability, itself a contested and contestable concept which we will shall undoubtedly hear more argument about as it becomes encoded

into law.⁹ She shows how the conclusions drawn have led to another root and branch reform of financial regulation.

It was clear that Northern Rock's mortgage assets could not be funded from deposits alone. Northern Rock had in fact shifted its position from relying on organic growth through a rising deposit base to sourcing funds from other sources. This was explained by the description used by Northern Rock as 'a specialised lender, whose core business is the provision of UK residential mortgages funded in both the retail and wholesale markets'¹⁰.

This shift in Northern Rock's funding pattern gave rise to two issues. First, how good was the quality of the asset base of Northern Rock? Second, did the liabilities side of the balance sheet present any special risks? In relation to the first question, the position was that this was not a significant factor at the time the crisis commenced. It was only later that the lending policy of Northern Rock would come under scrutiny and reveal a policy which had changed significantly from low to high risk for at least part of the mortgage portfolios. The same cannot be said in relation to the second question. Northern Rock had, as previously mentioned, traditionally funded its lending from savings deposited by its customers, but by 2006 only about 25 per cent of its funds were coming from its depositors, with about 75 per cent being raised from the money markets through borrowing or by the use of securitised products.¹¹ It was this change of strategy, as Akseli and Aldohni discuss in their contributions, that was the catalyst for the commencement of the crisis. Akseli shows how the highly technical and, so often misunderstood, private law processes of securitisation serve to shift credit risk from originators to buyers and ultimate holders and argues that, although much can go wrong in this process with room for mispricing and flawed signalling, the process of securitisation itself is not to blame. Rather he argues for more coherence and transparency in the environment in which securitisation takes place, along with greater understanding of the limitations and possibilities of securitisation.

Hamilton, in her contribution to this collection, examines the role of the 'safety net' of compensation scheme, widely in use around the world to repay depositors in defaulting financial institutions a maximum amount in respect of monies held on deposit. She looks at how the UK scheme was hastily amended just after the Northern Rock run and indeed superseded by a Government guarantee of all Northern Rock deposits during the course of the bank run as

the existence of the UK Financial Services Compensation Scheme (FSCS) appeared to have little effect on preventing the run on Northern Rock, which happened despite the scheme's guarantee before the run commenced of over £30 000 in deposits, subsequently raised to £35 000 and then £50 000. She asks the questions 'what is the real reason these schemes exist?' and 'why are they subject to a maximum upper limit of compensation?'. Is the underlying rationale for such schemes genuine consumer protection? Or promotion of financial stability? Or indeed a deliberate engineering of the autonomous financial citizen and a downward-shifting of the consequences and effects of uncertainty and risk to the individual away from the government/regulatory level of responsibility?

This latter argument has resonance in Gray's consideration of the shifts in regulatory culture and form in UK financial regulation and her conclusion that the emergent macroprudential regulatory agenda that is to be designed to deliver financial stability risks repeating the same over-promising and under-delivery that has characterised the FSA's approach to regulation that has followed the last government's 1997 settlement in financial regulation.

De Cecco explains and examines how EU State Aids law has played a leading role in post-crisis rescue and repair of failed and troubled financial institutions throughout Europe. He considers how the European Commission has attempted to construct a rational and coherent basis to the manner in which national governments across Europe have supported national financial institutions. He shows that discerning a theoretical rationale for many of the post-financial crisis State Aids decision that is both consistent with the core objectives of the European Union as well as the need to maintain financial stability and the ways in which the processes to maintain that stability are commonly understood is no easy task. The dividing line between financial regulation and State Aids law has been blurred by the financial crisis and complementary although the two regimes are in some respects, in other respects there are distinct tensions as De Cecco shows.

Aldohni concludes by asking questions about the very inner essence of modern finance, the way in which its protagonists and conduits are organised globally suspended above national, regional or any other spatial loyalty, and the way in which its measures of value have become far removed from discernible non-financial economic activity and human endeavour. His discussion is redolent of

a question recently posed by John Kay in a *Financial Times* essay in which he uses the historical metaphor of medieval banditry in the trading routes along the waterways of Northern and Central Europe to challenge the financial system to more effectively locate the ‘distinction between those who add value to cargo and those who help themselves to a fraction as it sails by. . .’.¹² Aldohni explains the principles and practices of Islamic Finance and how they are underpinned by an ethical and belief system. He goes on to suggest Islamic Finance might offer a mode of financial intermediation that would not have allowed for the lack of discipline and shouldering of responsibility that was apparent at so many stages of the recent financial crisis (whether it be lax securitisation practices, excessive and irresponsible lending or indeed borrowing behaviour). Its emphasis on real physical assets and its insistence on institutions’ sharing losses of economic activity as well as profits, he argues, has the potential to operate as a brake on the kind of irrational exuberance that so nearly brought down the modern financial system. However, he concludes that Islamic Finance in its current manifestation, albeit a growth sector, is not without its own problems and he questions whether it does at the moment present a real and viable alternative.

The editors and authors would like to make it clear that the material contained in this book reflects developments up to September 2010 only.

NOTES

1. Building Societies Act 1986.
2. Providing that the capital gain was less than the appropriate personal capital gains allowance which applied at the time of the sale there would be no capital gains tax to pay unless the seller had made other capital gains during the relevant tax year.
3. Interestingly, not all votes to demutualise have succeeded. For example, the members of the UK’s largest building society, the Nationwide, voted against demutualisation. For judicial discussion of the nature of an organisation member’s right to receive payment upon its demutualisation see *Needler Financial Services Ltd v Taber* Chancery Division [2002] 3 All ER 501; *Money Markets International Stockbrokers Ltd (in liquidation) v London Stock Exchange Ltd and another* Chancery Division [2001] 4 All ER 223.
4. The former Leeds Permanent Building Society had previously merged with the Halifax.
5. Twenty-one of these are in the north east of England, as is the head office.

6. Northern Rock Annual Report 2006 p. 31.
7. Ibid. p. 82.
8. Hereafter 'FSA'. There has been much criticism of the role played by the Financial Services Authority, but it is beyond the scope of this chapter to consider regulatory aspects. For further reading on this see the report of the House of Commons Treasury Select Committee *The Run on the Rock* (5th Report of Session 2007/08, House of Commons, January 2008).
9. An unsuccessful attempt was made with the backing of the Icelandic Government to argue that the UK Treasury had been wrong in its interpretation and application of its powers of emergency intervention used to intervene in the UK subsidiary of the Icelandic bank Kaupthing hf when it judged it could do so for the legislative purpose of '.. maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made. . . .' Contained in section 2 of the Banking (Special Provisions) Act 2008
10. *Report Northern Rock Community* (Northern Rock, 2006) p. 9.
11. For detailed information on this see the *Run on the Rock* supra note 10.
12. Kay, John 'On guard against the robber barons of the Rhine' *Financial Times*, 18 August 2010.